COMPETITION AND CONSOLIDATION IN FINANCIAL MARKETS

HEARING

BEFORE THE

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INTELLECTUAL PROPERTY,
COMPETITION, AND THE INTERNET

OF THE

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APRIL 1, 2011

COMPETITION AND CONSOLIDATION IN FINANCIAL MARKETS

FRIDAY, APRIL 1, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTELLECTUAL PROPERTY,
COMPETITION, AND THE INTERNET,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to call, at 11:05 a.m., in room 2141, Rayburn Office Building, the Honorable Bob Goodlatte (Chairman of the Subcommittee) presiding.

Present: Representatives Goodlatte, Sensenbrenner, Chabot, Marino, Quayle, Watt, Conyers, Jackson Lee, and Waters.

Staff present: (Majority) Holt Lackey, Counsel; Olivia Lee, Clerk; and Stephanie Moore, Minority Counsel.

Mr. GOODLATTE. Good morning. The Subcommittee will come to order. And I will recognize myself for an opening statement.

The complexion of this hearing has changed considerably in the last few hours. When we went to bed last night, the primary focus of the hearing was the proposed merger between the New York Stock Exchange Euronext, parent company of the New York Stock Exchange, and Deutsche Borse, a leading German-based securities and derivatives exchange company. Overnight, NASDAQ, OMX, and the IntercontinentalExchange announced a joint proposal to purchase NYSE Euronext. This Committee remains very interested in evaluating the competing bids by Deutsche Borse and NASDAQ, and their effects on competition and consumers.

At this point, a proper evaluation of the competing bids demands a hearing at which the executives from the New York Stock Exchange, NASDAQ, and Deutsche Borse have an equal opportunity to debate the merits of the issue.

This morning's hearing was scheduled to include a witness from NYSE, but not from NASDAQ or Deutsche Borse. In consulting with representatives for all three companies this morning, it became clear that there was no possibility of having executives from all three testify today. In any case, testimony today would likely have been premature.

At this point, it would not be appropriate to take testimony only from the New York Stock Exchange without giving the other companies an equal forum. For this reason, the Committee decided to cancel the appearance by the NYSE at this morning's hearing, and we will hold a hearing soon at which we will take testimony from the interested companies and perhaps other witnesses.

This morning's witness panel also included two expert witnesses, Professor Larry Harris of the University of Southern California, and Professor Mercer Bullard of the University of Mississippi. These distinguished professors have traveled across the country to assist the Committee in its evaluation of competition in financial markets. They are both ready and able to testify. This Committee and the public will benefit by the insight that they can shed on these important issues. We will, therefore, proceed today with what will now be part one of a two-part hearing on Competition and Consolidation in Financial Markets.

Today's hearing will take testimony from our two expert witnesses. A hearing in the near future will take testimony from executives of the three interested companies.

It would be premature for anyone to draw definitive judgments about the newly-announced NASDAQ proposal or the relative merits of the two proposals, but it is appropriate to begin considering these profound issues without delay. The New York Stock Exchange sits near the center of the American economy; events on Wall Street ripple through our economy with profound effects for every American. The stock market crash of 1929 contributed to the Great Depression, the most harrowing and prolonged period of unemployment and economic instability in our Nation's history. The crash of 2008 helped precipitate our current economic downturn, and unemployment remains around 9 percent.

When he became CEO of the New York Stock Exchange in 2007, Duncan Niederauer said, "As NYSE Group reshapes its business model, it reshapes global finance." I agree. The shape of the future of global finance is at stake. Congress and the Department of Justice must evaluate these proposed deals with the utmost diligence and fairness. The future of American business and jobs are inextricably tied to the future of the New York Stock Exchange.

It is now my pleasure to recognize the Ranking Member of the Committee, the gentleman from North Carolina, Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

I have scrapped my opening statement and will make a few observations off the cuff, which is always dangerous, but I think necessary under the circumstances.

First of all, I want to applaud the Chair's decision not to press to have the New York Stock Exchange represented here today. I am not sure that I am exactly in accord with where the Chair is leading us on the next stage of this because I have some reservations about whether it is this Committee's or the government's role to start to assess competing merger proposals or takeover proposals before there is a final agreement between parties, at which point our role obviously is to evaluate the antitrust or potential antitrust consequences of whatever agreement has been reached by the parties, not some theoretical possible agreement that might be reached by the parties. In other words, I am not sure I think it is appropriate for us to be putting our finger on the balance and tipping the scale either toward the NASDAQ merger or the other merger that was already out there. But that is a subject of another day, and I obviously do not want to have a public debate with my Chair about that today.

I do think it is important to have what we are about to have today, and that is an academic discussion about this question of concentration, the implications that it has, whether there are potential antitrust implications from the growing concentration in this area, as we have expressed concerns about concentration in other areas. And so, for that purpose I certainly welcome these two outstanding academicians to have an academic discussion because I think they are well equipped to guide us in that discussion. And what we learn from academic discussions educate us and allow us to make better decisions as we go forward, regardless of which direction we go forward in.

So I welcome the witnesses. I thank them for the sacrifices they have made to be here. It would have been a shame to have you travel all this way and then not have your perspective on the concentration issues and the potential consequences of mergers. But I hope that we will not put you in the awkward position of trying to evaluate either one of these proposed mergers without enough detail about the real body of what the merger would look like or consist of.

So, I welcome you and thank you for being here.

And with that, Mr. Chairman, I yield back the balance of my time.

Mr. GOODLATTE. I thank the gentleman for his very pertinent comments, and we certainly will take them into full consideration as we plan for that subsequent hearing.

The Chair would ask the Ranking Member of the full Committee if he has any opening statement that he would like to make.

Mr. CONYERS. Yes, sir.

Mr. GOODLATTE. The Chair recognizes the gentleman from Michigan for 5 minutes?

Mr. CONYERS. Thank you very much. I am delighted to be here and to have this hearing. We welcome our witnesses.

But for the life of me, I do not see what has changed, outside of the fact that there is now a new bidder in this ballgame. What about next week when a fourth company comes in? We want to cancel another meeting? I do not think so.

I want to just indicate we are in a wave of mergers that have only been slowed down by the fact that the American economy is in the worst circumstance since 1929. And so, for us to be concerned about every time a bunch of Wall Street actors decide that this is a ripe opportunity for them to take over something, or make yet another acquisition, that we have got to wait to see what happens then, to me is no reason for us to stop the examination of mergers and acquisitions that go on in this country.

And while I am at it, we should take another good look at the title, “Competition and Consolidation in Financial Markets.” Guess what? Competition and consolidation are antithetical. You do not get the same results from both of them. And for us, it is important to me that our distinguished witnesses separate this out. What happens when consolidation keeps going on at the greatest wave of mergers that have occurred since the turn of the 20th century? And here we are again in the midst of another.

And so, I just want you to know that the adjournment proposal is totally unacceptable to me. It would do the same thing that any other merger would do in this financial area, a reduced consumer choice. It will cost us jobs and create a massive transnational regulatory issue in terms of how we can regulate such a global combined entity.

But the latest offer is worse. Now we are talking about General Motors and Chrysler coming together as if that is going to help the automobile industry and job creation in Detroit and the United States. This is totally unacceptable. Oh, is there more being offered and put on the table, Chairman Emeritus? Yes, there is more being put on the table, but that does not make it any better. This would be another takeover within the United States.

And so, I would like to revise and extend my remarks and wait for the comments of our two witnesses. And I thank them for their appearance.

Mr. GOODLATTE. I thank the gentleman, and we have a diversity of views about the appropriate way to proceed here. And we will proceed by hearing from Professor Harris and Professor Bullard, but first we have a series of votes on the floor, and we will resume as soon as those votes have concluded.

The Committee stands in recess.

[Whereupon, at 11:18 a.m., the Subcommittee recessed, to reconvene at 1 p.m., the same day.]

Mr. GOODLATTE. Before I introduce our witnesses, we would ask you both to stand and be sworn in.

[Witnesses sworn.]

Mr. GOODLATTE. Thank you, and be seated.

You have little lights in front of you there which will turn on in just a minute, and they indicate the 5 minutes. We ask that you summarize your testimony in 5 minutes. When it gets to 1 minute remaining, a yellow light will come on, and then when the red light comes on, your 5 minutes are up. Your entire statement will be made a part of the record whether you verbally get it out here or not, so do not worry about that. And give us the best points.

And we will start with Professor Harris, who is a scholar who literally wrote the book on trading and exchanges. His 2003 book titled, Trading and Exchanges: Market Microstructure for Practitioners, is widely regarded as a must read for entrance into the securities industry.

From 2002 to 2004, Professor Harris served as the Chief Economist at the Securities and Exchange Commission. As Chief Economist, Harris was the primary advisor to the Commission on all economic issues. He contributed extensively to the development of regulations, implementing Sarbanes-Oxley, the resolution of the mutual fund timing crisis, the specification of regulation NMS, which stands for National Market System, the promotion of bond price transparency, and numerous legal cases.

Professor Harris currently holds the Fred V. Keenan Chair in Finance at the University of Southern California, Marshall School of Business, where his research, teaching, and consulting focus on regulatory and practitioner issues in trading and in investment management.

Professor Harris, welcome.

TESTIMONY OF LAWRENCE E. HARRIS, FRED V. KEENAN CHAIR IN FINANCE, PROFESSOR OF FINANCE AND BUSINESS ECONOMICS, MARSHALL SCHOOL OF BUSINESS, UNIVERSITY OF SOUTHERN CALIFORNIA

Mr. HARRIS. Thank you very much, Mr. Chairman.

Voice. Press that button there. There we go.

Mr. HARRIS. Now does it work?

Mr. GOODLATTE. Yes.

Mr. HARRIS. Very good.

Thank you, Mr. Chairman, Mr. Watt, and Members. Thank you for inviting me.

A number of competition issues are coming before the country at this point in the area of market microstructure, which is the structure of how we organize our trading in the United States. I would like to highlight what the competitive issues are and then comment very briefly on the two proposed transactions that we have before us.

First of all, within markets, we have a very strange situation that we do not see in other industries. We are all generally in favor of competition, but there actually are two competitions that take place in the marketplace for stocks or for bonds, options or futures, or even currencies. And the two competitions are these:

The first competition is the competition among traders to find the best price. The buyers are looking for sellers, and the sellers are looking for buyers. The buyers, of course, want the lowest prices, and the sellers want the highest prices.

The second competition is the competition among exchanges and other entities that behave like exchanges—dealers, brokers—to provide the forum for the first competition. So, the second competition is the New York Stock Exchange competing against NASDAQ, or the Chicago Mercantile Exchange competing against life in Europe.

Now, it turns out that it is very difficult to be in favor of both of these competitions and still be consistent. To make it as easy as possible for a buyer to find a seller, we could just require that everybody come to a single exchange by putting them all in a single place and time, and it is very cheap for them to find each other. But in doing so, we eliminate the competition among exchanges. And the competition among exchanges is something we respect because it promotes low cost trading, innovation, and because, frankly, we are, as regulators, we would not be certain what the proper market structure is by letting the market or the marketplace discover for itself what is the best structure, whether trading should be—rewards should be given to people who arrive first or to large traders or to the traders who expose those orders. These are all issues that have to be decided by exchanges.

Exchanges compete with each other to provide a set of trading rules that will be attractive to the traders, who themselves are competing among themselves to get the best price. So, there is this tension between the two types of trading, and when we talk about competition, we always have to be aware of that tension.

Consolidation is good for the traders as long as the consolidation is through a market that they like. But consolidation is not good for the competition among marketplaces because it effectively creates monopolies.

So, those are things to keep in mind as we start thinking about transactions.

Now, I would like to take a quick survey of the types of competition that we see among the exchanges as we consider the mergers that have been proposed by these three players, NYSE, Deutsche Borse, and NASDAQ.

The first competition we have to think about is the competition to provide exchange services, a place where people trade. In the United States, we see these competitions in equities, futures, and options. And in the equities market, the market is extraordinarily complex—competitive. We have an awful lot of competition in that area. The mergers that we are seeing here are not going to affect it. Even a NASDAQ merger with the NYSE will not make much difference.

In the futures markets, that is not an issue that is engaged here in the United States. There are some issues in Europe, but we will let the Europeans deal with it. I can comment about that later if you would like.

In the options markets, we have presently nine options exchanges. Although those options exchanges are often—several of them are held by single entities. If the New York Stock Exchange were to merge with Deutsche Borse, one of the major entities, the International Stock Exchange—Securities Exchange, I forget—ISE—would then come under a common control and we would see more concentration.

That said, it is very easy to start options exchanges in the United States. BATS just started an exchange, and the market share is growing rather quickly, so I am not particularly worried about any of these mergers with respect to options.

Where I do have concerns is with respect to listings. A merger between NYSE and Deutsche Borse will not have much effect on the listing market in the United States, but a merger between NASDAQ and NYSE would concentrate virtually all the listings into a single market, and that would be quite problematic.

[The prepared statement of Mr. Harris follows:]

Prepared Testimony of

Lawrence E. Harris, Ph.D., CFA
Fred V. Keenan Chair in Finance
USC Marshall School of Business

U.S. House of Representatives
Committee on the Judiciary
Subcommittee on Intellectual Property, Competition and the Internet
Hearing on Competition and Consolidation in Financial Markets
Washington, D.C.
April 1, 2011

I. Introduction

My name is Larry Harris. I am a professor of finance and business economics at the USC Marshall School of Business where I hold the Fred Keenan Chair in Finance. I formerly served as Chief Economist of the Securities and Exchange Commission where, among many other activities, I contributed substantially to the specification of SEC Regulation NMS. I have written extensively on the economics of exchange markets. I am the author of *Trading and Exchanges: Market Microstructure for Practitioners* (Oxford University Press, 2003), which has become the standard introduction to financial market structure for both university students and market practitioners. I am also a director of Interactive Brokers, Inc., a NASDAQ-listed broker-dealer that operations in electronic exchange markets throughout the workd, and of the Clipper Fund, Inc., a large cap equity mutual fund.

This written testimony and my oral comments today represent my opinions only and in particular do not necessarily represent the views of the University of Southern California, Interactive Brokers, Inc., or the Clipper Fund, Inc.; or of any of their associated personnel.

II. Summary

We are gathered today in large part to discuss the proposed merger between NYSE Euronext and Deutsche Börse. If completed, the combined firm would become the world's largest exchange operator.

The proposed merger would decrease the costs of providing exchange services, but otherwise would have little effect on the existing competition among exchanges to provide exchange services for equities in the United States. The NYSE and its affiliates would continue to be subject to competition from numerous other exchanges and trading systems that presently operate in the US.

If desirable, these other competitors could merge with other strong providers of securities exchange services in Europe such as the London Stock Exchange, Turquoise, Chi-X, or BATS Europe to obtain many of the benefits that the NYSE Euronext and Deutsche Börse presumably hope to obtain from their merger.

The new entity would obtain some advantage over NASDAQ in the provision of listing services by becoming the world's biggest exchange services company. This advantage would not be a significant source of market power.

The proposed merger would result in greater concentration of control over European futures contract markets. These markets are already essentially uncontestable monopolies. Placing them under common control will not change the underlying economics, but some resulting cost efficiencies may benefit their customers. The combined entity would be better able to compete with OTC trading of derivative contracts.

The merger would also result in greater concentration of trading in U.S. exchange listed options. However, this market is relatively easy to enter. If entry does not become restricted, the increased concentration should not harm the public.

My most significant concerns about competition in the financial markets involve the vertical structure of futures contract markets where exchange services and clearing services are under common control. Although this issue is beyond the scope of these hearings, I note that the US exchange-traded options contract markets provide a very successful model for market structure. The public would benefit if our futures industry adopted it. Any such adoption would require regulatory intervention, which seems very unlikely in the current environment in which our futures markets generally operate quite well and without much public criticism.

III. Consolidation among Exchanges

Exchanges have been consolidating for more than a century, largely in response to the development of new communications and information processing technologies. The inventions of the telegraph and later the telephone allowed traders to learn about trading opportunities at distant exchanges and to communicate their intentions to floor traders working on remote exchange trading floors.

As these communications systems matured, those exchanges that had the most order flow attracted more orders because traders can most easily arrange trades where other traders trade. Exchanges merged to aggregate their order flows and thereby make their combined markets more attractive to traders. Those exchanges that did not grow generally failed. These mergers greatly reduced the costs of trading by allowing buyers to find sellers, and vice versa, more often without the intermediation of dealers and arbitrageurs.

Where the public commonly traded only with dealers, such as in the early NASDAQ markets, innovations in communication technologies lowered the costs to dealers of participating in dealer networks, and thereby attracted their participation.

Economists call the tendency for orders to attract more orders the "order flow externality." It is a network externality because the value to any participant of sending an order to an exchange increases with the number of participants using the exchange. Practitioners simply say that "liquidity attracts liquidity."

In the United States, the order flow externality eventually led to the consolidation of almost all trading in a given stock to one of the three primary listing exchanges at which the stock was, and generally continues to be, listed: The NYSE, Amex, or NASDAQ. Some trading took place in regional exchanges and in dealer markets, but for the most part, traders chose to route their orders to the primary exchanges because only there could they easily obtain the best prices.

The order flow externality gave these primary exchanges market shares in excess of 80 percent despite customer dissatisfaction with the generally low quality services they received and the high fees that they paid. Innovative and cheaper exchanges could not attract order flow away from these incumbents because their markets simply were not liquid.

The development of high speed electronic trading systems changed this situation. These systems allowed traders to offer liquidity and to search for liquidity in multiple markets at the same time. Clever uses of these technologies greatly reduced the value of the order flow externality to the primary listing exchanges.

NASDAQ was the first primary listing market to lose substantial market share to new systems such as Island, Instinet, and Archipelago, which the SEC classified and regulated as Electronic Communications Networks (ECNs). These marketplaces could successfully compete against NASDAQ because NASDAQ operated a relatively fast electronic trading system in which the ECNs could post orders on behalf of their clients. ECN customers thus could benefit from liquidity at NASDAQ or at the ECN. The ability to participate simultaneously in both venues made the ECNs very attractive to traders, and ultimately led to very substantial market share losses at NASDAQ. This competition was successful against NASDAQ because NASDAQ's fast electronic trading system allowed the ECNs to cancel orders quickly when the ECNs could fill these orders in their own trading systems, and thereby avoid double jeopardy—filling the same order twice.

Competition from ECNs did not have a significant effect on NYSE or Amex market shares until the SEC adopted Regulation NMS. Before its adoption, these two floor-based exchanges could not—and often would not—cancel orders quickly enough to ensure that ECN orders would not be filled twice. The ECNs would have to wait up to 15 seconds or more to learn whether orders for which they requested cancellation had been canceled or executed. The floor-based exchanges were necessarily slow reporting the cancellations because floor traders often were negotiating trades or reporting trades for these orders when the order cancellation requests arrived. The slow floor-based NYSE and Amex exchanges thus retained their dominant positions in the face of ECN competition because traders could not effectively participate in ECNs and in these primary markets at the same time.

Regulation NMS changed this situation by reorienting the yield sign between floor-based and electronic trading systems. Before Reg NMS, no participant in the National Market System (NMS) could trade through—trade at a price inferior to—

any other NMS quote. This rule forced electronic trading systems to yield to slower floor-based trading systems. Following Reg NMS, no NMS participant could trade through any electronically accessible quote, but electronic systems could trade through slow floor-based quotes. The NYSE and Amex quickly adopted electronic trading systems to remain competitive. These systems allowed traders in the ECNs to interact with primary market liquidity as they had for NASDAQ. The NYSE and Amex market shares dropped as the above-mentioned ECNs, and new low cost ECNs such as BATS and Direct Edge, successfully competed with them, and in many cases, acquired enough native order flow to survive on their own.

The ability to instantly search for liquidity throughout the National Market System has now reduced the importance of the order flow externality so that multiple exchange systems are effectively competing with each other.

The maintenance of these electronic trading systems is expensive. Exchanges now are consolidating to reduce the costs of maintaining functionally similar trading systems. The costs of running nearly identical trading systems for two markets are not much higher than for running one system for one market. Thus, exchanges can decrease their IT costs substantially by merging. The reduction in the number of exchanges also reduces the costs that brokers must incur to connect to multiple exchanges. The Chicago Mercantile Exchange purchases of the NYMEX and Chicago Board of Trade were motivated in large part by their desire to decrease the combined costs of running the three exchanges.

IV. Expected Benefits of the NYSE Euronext—Deutsche Börse Merger

A primary benefit of the NYSE Euronext merger with the Deutsche Börse will be the reduction of duplicative IT costs. The combined firm will likely adopt a single technology platform for all of its markets, which would substantially reduce its development, maintenance, and operational costs. The merged firm undoubtedly also will provide a single data port for its brokerage and proprietary trading clients through which the clients could direct order flow to any of its exchanges. This facility would make trading through the combined firm more attractive to the brokers and proprietary traders that route orders to the exchanges.

A secondary benefit of the merger will be the creation of an entity that could easily consolidate trading in a given security across its markets, if the regulatory impediments to such consolidation are ever relaxed. Until then, the combined firm will simply be a holding company that will separately operate several different exchanges subject to various regulatory jurisdictions.

Some of these exchanges presently trade similar securities. For example, Siemens primarily trades at the Deutsche Börse, but it also trades at the NYSE as an American Depository Receipt (ADR). Many US stocks likewise trade in the European markets.

If regulators permitted exchanges to operate their trading systems in two or more regulatory jurisdictions at the same time, many exchanges would consolidate their order books into a single system so that a buyer in Europe could seamlessly trade with a seller in the US and vice versa. With the addition of one or more Asian markets, such an exchange could operate around the clock. The combined entity would enjoy the benefits of the order flow externality.

Presently, issues involving regulatory oversight, currency translation, and clearing and settlement complicate the consolidation of trading across international markets. Instead, individual exchanges increasingly operate their markets around the clock. Brokers and proprietary traders connect directly to these markets if permitted to do so, or they connect through foreign subsidiaries or through correspondent relationships. By creating a single entity, NYSE Euronext and Deutsche Börse undoubtedly ultimately hope to reduce the costs of creating viable 24 hour markets in which all trading in a given security will be directed to a single exchange trading system.

V. Competition in Derivative Markets

The economics discussed above apply only to security markets for which clearing and settlement procedures allow traders to trade the same security in many different markets. These facilities are the norm in the securities markets, but they generally do not exist in futures markets and in many non-US options markets.

In contrast, almost all futures markets and some options markets are vertically integrated so that a single entity controls the exchange where the contracts trade and the clearinghouse that guarantees the performance of those contracts. Not surprisingly, these companies require that all contracts that they clear trade only on their exchanges.

Since common clearing allows traders to contract with any trader, and to offset their positions with any other trader, traders strongly gravitate to exchanges with the most active trading and the greatest cleared open interests. The order flow externality thus is a particularly strong force in future markets.

Creating contracts that will compete successfully against well-established contract markets is extremely difficult for new exchanges. The only effective competition that well-established futures contract markets have is from OTC derivative contracts. The vertical integration of futures markets explains why the CME and other futures exchanges are such profitable exchanges in comparison to securities exchanges that process far more trades.

The CME mergers with NYMEX and with the Chicago Board of Trade vastly concentrated control of future trading in the United States. However, these mergers had little effect on competition because each of the major futures contract markets—with the possible exception of some of the NYMEX energy contract markets, was already individually essentially an uncontestable monopoly. (The exceptional NYMEX energy contracts experienced substantial competition from ICE because the NYMEX was a very slow and inept adopter of electronic trading technologies in a space where international energy firms had become used to electronic trading through their dealings with other exchanges and with Enron.)

The effect on competition of the combination of the NYSE Euronext's Liffe futures markets with the Deutsche Börse Eurex futures markets will be comparable to that observed for the CME mergers. The resulting company will concentrate control of future trading in the Europe, but the transaction will have little effect on competition because most of the major futures contract markets are already essentially uncontestable monopolies. Placing them under common control will not change the underlying economics.

Exchange-traded options markets in the United States have a more competitive market structure. In these markets, the Options Clearing Corporation (OCC) clears contracts that trade at nine US options exchanges. A buyer who buys an OCC-cleared contract at one exchange can offset her position by selling any exchange where that contract also trades. Unlike the futures exchanges, US options exchanges thus compete with each other to provide execution services. The OCC operates as an industry utility that charges its members for services and rebates excess fees to those members.

If the proposed merger occurs, the combined firm would control three US options markets: NYSE Amex Options, NYSE Arca Options, and the International Securities Exchange (ISE), which Deutsche Börse's Eurex division presently owns. NASDAQ presently owns three other exchanges: NASDAQ Options Market, Boston Stock Exchange, and NASDAQ OMX PHLX (the former Philadelphia Stock Exchange). CBOE Holdings, Inc. owns two US options exchanges, the Chicago Board Options Exchange and C2 Options Exchange. The last options exchange, BATS, presently has a 1.9% (and growing) market share of listed options trading. Following the merger, three major entities will control almost all exchange-listed options trading.

The concentration of option trading in these three entities is troubling, especially if they can exercise substantial control over the OCC. The proposed merger would present fewer concerns about competition if the ISE were spun off so that four (five counting BATS) significant independent competitors would remain. That said, the costs of entering the options exchange space is relatively low. Indeed, three of the current eight OCC participant exchanges started up only in the last few years. Accordingly, the increased concentration in the US exchange-traded options space should not increase pricing power too much unless the remaining exchanges can prevent new exchanges from becoming OCC participants.

VI. Competition in Listing Services

The NYSE Euronext provides listing services to its listed firms. In the United States, NYSE- and Amex-listed issuers pay NYSE Euronext listing fees in exchange for which NYSE Euronext provides various services primarily designed to increase investor confidence in the issuer's securities. These services include the regulation of corporate disclosure, capital structure, and governance standards, and the organization of various media events designed to increase investor awareness. These services are valuable because public investors have come to associate an

NYSE or Amex listing as a standard of quality. NYSE Euronext and its predecessors have actively cultivated their listing brands over more than 100 years.

In the United States, NASDAQ is the only other major exchange providing listing services. NASDAQ has cultivated a high tech image for its listing brand. As the technology industries grew over the last 30 years, the NASDAQ listing came to have substantial value.

NASDAQ's ability to penetrate the listing market and develop its brand was largely due to the early patronage of computer technology companies like Microsoft. These companies remained listed at NASDAQ long after their growth normally would have led them to switch to the NYSE. These information technology companies identified with NASDAQ because NASDAQ's distributed electronic network market structure represented a strong example of the vision that they were promoting to their own customers. Without this unique advantage, NASDAQ's listing business probably would never have developed to its present extent.

NYSE Euronext and NASDAQ now very actively compete with each other to obtain primary listings. Both companies have large marketing departments that cultivate issuer relationships. Both regularly tout their successful attractions of new IPO listings, and they both publicly rejoice when issuers defect to their exchange from the other exchange.

The proposed merger of NYSE Euronext and Deutsche Börse would confer some competitive advantage to the combined entity in its competition with NASDAQ and with competing European exchanges to provide listing services. Subject to meeting diverse regulatory requirements across exchanges, the new entity could offer "one-stop" listing services for issuers interested in accessing capital in multiple markets. As the largest operator of equity exchange markets, the new entity also would provide greater reputational value to its issuers through branding by the world's biggest exchange services company.

Since the announcement of the proposed merger of NYSE Euronext with Deutsche Börse, many stories have appeared in the press about the potential for a NASDAQ-led attempt to acquire break up the proposed merger and acquire the NYSE for itself. Such a combination would raise substantial competitive concerns for listing services.

The resulting combination would control essentially all US primary market listings. Since the value of a listing depends critically on the reputation associated with the listing, and since brand reputations are very difficult and expensive to acquire, the barriers to entry to new competitors in the listing business are very substantial. A combined NYSE — NASDAQ entity could have substantial pricing power in the listing business. Such concentration also could reduce innovation in listing standards, which might not be in the public interest. In addition, the combined firm might use the revenue raised from its listing business to cross-subsidize its exchange services businesses to the detriment of other securities exchanges that compete only in this space.

VII. Alternatives to Merger

Since the announcement of the proposed merger between NYSE Euronext and Deutsche Börse, some commentators have expressed concern about the transfer of a flagship American institution to a foreign entity. This characterization of the transaction may be somewhat misleading because the NYSE Euronext and Deutsche Börse both already are international companies held by investors from throughout the world. In part to address concerns about this issue and to emphasize the international character of the combined entity, the companies propose that NYSE Euronext CEO Duncan Niederauer will become CEO of the merged firm while Deutsche Börse CEO Reto Francioni will become chairman.

Regulators or legislators who oppose the merger for whatever reason should be aware of the potential costs associated with their positions. The most obvious costs would be the lost cost cutting opportunities and the lost order flow consolidation opportunities described above.

Regulators should evaluate these costs relative to the costs of the alternatives that these firms might pursue if they cannot consolidate. For example, smaller exchanges facing substantial technology costs often contract with other exchanges and software development companies to reduce the costs of developing, maintaining, and operating their systems. Although such arrangements seem unlikely for very large exchanges, exchange technologies are highly scalable so that size alone is not a significant barrier to such arrangements.

The two companies also could form a joint venture for the purpose of developing, maintaining, and operating their trading systems while otherwise remaining independent competitors. Joint ventures are common across many industries including finance, but coordination issues and conflict of interest issues among the partners often make them difficult to operate efficiently.

Finally, note that many brokers and various providers of exchange information services already provide order routing facilities to their clients and to correspondent brokers seeking linkages to multiple exchanges. These services are presently readily available to brokers and proprietary traders even if NYSE Euronext and Deutsche Börse were unable to provide common order entry portals through a merger or a joint venture.

Mr. GOODLATTE. Thank you, Professor Harris.

Our second witness is Mercer Bullard, an Associate Professor of Law at the University of Mississippi. Professor Bullard focuses his scholarship and teaching on securities, banking, corporations, corporate finance, and law and economics. He is also the founder and president of Fund Democracy, an advocacy group for mutual fund shareholders, and a senior advisor with the wealth management firm Plan Corp, Incorporated.

He currently serves as the Securities and Exchange Commission's Investment Advisory Committee member and the Public Policy Council of the Certified Financial Planner Board of Standards.

Before entering academia, Professor Bullard served as Assistant Chief Counsel at the Securities and Exchange Commission and practiced securities law at WilmerHale here in Washington, D.C.

Professor Bullard, welcome.

TESTIMONY OF MERCER E. BULLARD, ASSOCIATE PROFESSOR OF LAW, THE UNIVERSITY OF MISSISSIPPI SCHOOL OF LAW

Mr. BULLARD. Thank you, Mr. Chairman.

Chairman Goodlatte, Ranking Member Watt, Ranking Member Conyers, Members of the Committee, thank you for the opportunity to appear here today.

Professor Harris, I think, has covered in his testimony and in his statement today some of the more specific antitrust issues. What I would like to talk about is something I refer to as the regulatory market, and although my discussion might seem a little bit securities law laden to you, I believe the regulatory market is really an integral part of any evaluation of the competitive effects of any kind of merger in this business. That is because financial exchanges are not simply markets for trading of financial instruments that are also regulatory markets. Exchanges establish listing rules that are in effect a form of regulation themselves. In the United States, for example, the rules of national securities exchanges are approved and reviewed by the SEC, so exchanges do not have complete freedom to choose their rules. But the rules reflect the exchanges' general view of their position in this kind of regulatory market, and it is, to some extent, a private or privately-ordered regulatory market, the lines of which are drawn based somewhat on competitive forces, and not necessarily on state or Federal law.

Exchanges are also subject to Federal rules. They have no authority over those rules. If they want to operate a securities or other financial market in the U.S., they must follow Federal law.

Now this monopoly of Federal law has been possible because these financial markets have been manifested in tangible ways. They have trading floors. They have buildings for those trading floors. They used to trade actual stock certificates so they are even selling something that was arguably tangible itself. They had back offices where piles of trading slips accumulated over time. And essentially, there was something to regulate, and it was not easy for exchanges to go somewhere else.

Well, exchanges could lobby for changes in these Federal rules. They could not change them, and they could not really go anywhere else. Perhaps more importantly, issuers are subject to the Federal rules if they want to take advantage of these exchanges' services. For example, public companies are subject to the Federal proxy rules and Federal tender offer rules that effectively cannot be escaped if the company wants to raise capital in U.S. markets.

This monopoly has created a kind of regulatory equilibrium. Exchanges and issuers often lobby legislators and regulators in order to ease the burdens of regulation. Legislators and regulators sometimes create new rules and new burdens.

For better or for worse, the evolution of modern exchanges, principally as a result of technology, is threatening that equilibrium. The operation of modern exchanges has shed the tangible context that enabled the Federal monopoly over rules governing the raising of capital. U.S. issuers can now raise capital overseas in foreign markets, while bypassing U.S. securities regulation.

Now, only a small number of U.S. companies have gone public overseas, but that number is sure to rise, and the New York Stock Exchange/Deutsche Borse merger or, what I think are inevitably going to be more transnational mergers, is likely to accelerate that process of even U.S.-based companies doing IPOs and seeking capital overseas.

Now, is this kind of regulatory arbitrage a positive development? Well, that depends on your faith in free markets. Rest free markets, if left alone, will arrive in an equilibrium that results in the most efficient allocation of capital. If they do not, however, there will be no supranational overseer to set them straight. If they create systemic risk that threatens U.S. interests, it will be up to the host nation to take action.

The structure of corporate law provides an illustration of this dynamic. Some commentators consider the ability of corporations to choose the state laws under which they operate to create a kind of regulatory market. But it truly is not free. There is only a free market to the extents that Congress allows such a free market. Federal law can trump law, and often does.

Now, in the case of free international regulatory markets, there is no such parental oversight. No entity currently has the authority to step in and impose rules. This might not be a significant risk for the regulatory arbitrage that is going on between countries with highly-developed business regulatory regimes. However, Congress needs to think about this risk as the globalization of financial exchanges expands to less developed countries.

A parallel concern is the expansion of the self-regulatory state. Self-regulatory organizations may seek transnational regulatory authority to resolve the issue of parental supervision and oversight. They may have the flexibility and the resources to be quite successful; however, Congress should consider the implications that further derogation of administrative authority could have for broader national interests.

Transnational SRO is no longer a national SRO. The Supreme Court recently expressed concern that the constitutionality of SROs are already two steps removed from the authority of elected government officials. The transnational SRO structure will hardly mitigate that concern.

Congress should also consider ways to address the risk created by transnational exchanges and transnational regulatory arbitrage.

The multiplication of exchanges will increase the likelihood that U.S. retail investors will purchase securities in foreign markets without the protection of fundamental investor and shareholder rights that apply in the United States. This may militate for reforms to our regulation to the point of sale; and that is, at the broker-dealer or at the advisor point of sale, contact with the customer. And this is an illustration of how in some cases freeing up the regulatory marketplace in one area, for example, exchanges, can sometimes be balanced by adjustments in other areas, such as with respect to the duties of brokers, dealers, and other salespersons and advisors.

In conclusion, we could also look inward at our own private markets as potential outlets for a more flexible regulatory market. The current private offering rules, like the regulation of exchanges, have been overwhelmed by technological advances. Facebook's failed private offering in the United States illustrates the incompatibility of modern communications and the Securities Act's restriction on offers.

Congress should consider reforming restrictions on offers so that private markets can provide a more feasible escape valve for issuers that seek capital and more regulatory freedom.

So, the New York Stock Exchange/Deutsche Borse merger will take us another step down the road to free regulatory markets for financial exchanges. I strongly encourage Congress to look carefully down this road and think hard about where it is taking us.

Thank you again for the opportunity to appear before you today, and I will do the best I can to answer any questions you might have.

Mr. GOODLATTE. Thank you both. Those are both very instructive statements.

Professor Harris focused on the issue of competition amongst the companies that may want to list their securities on exchanges and the consumers, and how they might be affected by these mergers, and expressed concern that maybe two domestic mergers might reduce that more than the international. And you addressed an issue that I was going to ask you about, and you pretty much addressed it, in terms of the concern that I have had in the—how do we handle, in our responsibility of putting forth laws that are then translated into regulations, and not keep people from taking these transactions outside the United States to the lowest common denominator?

So, I am going to ask you to flip. I want you to comment on Professor Harris' observations about the competition from the standpoint of the consumer and from the companies being listed on these exchanges. And I will come back to Professor Harris and ask him to comment on your observations.

So, Professor Bullard, I will let you start with that.

Mr. BULLARD. I would be happy to. It is quite a challenge and a little bit intimidating.

But what I hear when I listen to a kind of antitrust analysis is, what is the demand side of the market, because that what is I have generally focused on, and that is what is the type of investor? What is the most efficient regulatory regime for that investor? And what I would like to see is an analysis that thinks about what is the appropriate role for individual retail investors, and how will these exchange mergers affect them? And what is the overarching U.S. policy as to how it wants to regulate those investors? That is really a separate question from the exchange mergers as such, but it is one that really stands behind them because I think Congress needs to decide where it wants to be with respect to retail investors going forward.

There are some proposals that have talked about some of the issues I discussed, and that is how you deal with this kind of transnational, super national law. The source of that law is intended to deal with investors as individuals who should be able to go out and choose whatever regulatory regime they want. Without those fundamental investor protections, they can opt for the antifraud rules of Germany, if they wish, as opposed to the SEC, and then buy German stocks on U.S. exchanges. Then I think Congress needs to decide it wants to go that way, and then the answer to the antitrust question would clearly be affected by that because some of these regulatory decisions will drive, to some extent, the antitrust issues.

If, on the other hand, Congress is committed to the structures that we have for the last 80 years, which is where we essentially draw a line—we decide what is at least a close approximation of a kind of investor with respect to which we want to have different rules, and it is clearly a paternalistic regime, but it is one that nonetheless has created the most liquid, deepest, most successful capital markets in the world, then that really goes right to your concern. In that case, the model that we would follow to deal with these issues and these antitrust concerns would be very different.

And we need to think about issues, such as how do we really want retail investors to be accessing the marketplace? If we are going to oversee the way they do so, there are serious questions about what role individual retail investors have buying stocks directly in the first place, not to mention buying stocks on overseas exchange perhaps where you have got fundamentally different investor and shareholder protections.

Mr. GOODLATTE. Thank you.

Professor Harris, you make a very valid point in creating this tension, or observing this tension, that exists between the two levels of competition that we are inviting with these exchanges, that it is perhaps easier to regulate the fewer the exchanges there are because there are fewer opportunities for people to go elsewhere. We would bring everybody together, and you have more competition at that lower level.

On the other hand, I would like you to address what Professor Bullard talked about in terms of the fact that it is not easier to regulate if they all escape to Europe or some other exchange that can be formed elsewhere, that it constitutes a race to the lowest common denominator.

Mr. HARRIS. Professor Bullard raises some very interesting issues that trouble all of us. I want to distinguish between the problems that we presently encounter and those problems that we have not yet encountered and may never encounter.

First of all, with respect to the transactions that we have seen already and that are proposed in the last few weeks, these are transactions that involve the ownership of regulated exchanges. The owners are not the ones that are primarily regulated; it is the exchanges themselves. So, the New York Stock Exchange, whether it is owned by New York Stock Exchange Euronext or whether it is owned by some consortium involving Deutsche Borse or NASDAQ, will continue to be regulated by the SEC. And all trading at the New York Stock Exchange will be under the same arrangement. So, the notion that we have these transnational combinations raising regulatory problems is, at this point, premature.

Now, one of the potential benefits of having these transnational combinations is that in some distant future, it might be possible with changes in the regulatory environment to allow German investors and U.S. investors to trade these same securities in the same trading system so that a buyer could easily find a seller regardless of whether they are in Germany or in America. And that would be very advantageous both for the American traders and for the German traders, making the market much more liquid.

But to get to that point, we would have to have a regulatory agreement between the regulators of those two exchanges to allow the merger of their order books and of their trading systems, at which point, of course, there would be some sort of negotiation, and we would have a strong arm in that negotiation because we could always say it should not happen.

Now, that said, the attraction of that is that you would now have a market that would operate maybe for 12 or 14 hours and would be liquid during that entire period. And the implication of that might be that, or the extension of that would be that they would bring in somebody in the Far East, and they have a 24-hour market.

But running against that is the fact that we already have 24-hour markets in many instruments, particularly the futures contracts, and we have markets that are moving toward 24 hours in the individual securities equities and whatnot. Those markets operate out of a single exchange, and, of course, we would like those exchanges to be U.S. domiciled, and often they are, but maybe they are not.

Presently in the United States, if you want to trade in a European exchange, you go through an American broker. The broker has a responsibility to you that is governed by regulations that are domiciled here in the United States. And so your relationship to the broker is governed by U.S. regulations, and that broker then takes you to the foreign market either through that broker subsidiary in the foreign market or through a correspondent relationship where the broker is responsible ultimately for your relationship to that market, subject to our laws. And so, we really have not lost that much control at this point over Americans who would be trading either in the United States or elsewhere.

So, those are things that are current and potentially future.

I want to address two, or at least one other quick point. People often speak about the loss of the IPOs in the United States, that this represents some sort of problem. And, in fact, the press releases that we saw this morning from NASDAQ referred to IPOs going abroad. So, the fact that IPOs are going abroad should be of concern to all of us, but we should also be mature about what it is happening. It could be happening for two reasons.

It could be happening because somehow we have failed and we have imposed significant costs on firms here in the United States, and we are driving them away. But the other reason, and a very likely reason, in my opinion, is that the other markets have simply become more mature. There is more liquidity in those markets, there is more financial sophistication, and they have simply become better competitors.

There was a time when an Israeli firm or a European firm in a smaller place would do its IPO in the United States simply because it had to because there were no good markets in Europe. As the Europeans have become more financially sophisticated and wealthier, and this is true also in Asia, they are doing more IPOs. And so, the fact that we do fewer IPOs is disappointing to us, but not necessarily a reflection of our regulations. It may be a reflection of the increasing sophistication and power from competitors that we see elsewhere.

Now, that is disappointing to us because we would like to have all of the business, but we also recognize that these people are our partners. We are all better off when everybody is wealthy. I would like to have more of that wealth here, but I am not going to cry too much about it.

Mr. GOODLATTE. Thank you. My time has expired. I anticipate we may do a second round, but we will now go to the Ranking Member, the gentleman from North Carolina, Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

Professor Harris, Professor Bullard, thank you for being here, and thank you for being patient while we were over booting. It has been a kind of a choppy experience for us this morning.

I perhaps have a little bias here because I serve not only on the Judiciary Committee, but on the Financial Services Committee. And it seems to me that most of what you all have talked about here, both the things that Professor Harris and the things that Professor Bullard addressed, we have been trying to deal with appropriately in the Financial Services Committee. The regulatory framework that Professor Harris just outlined very cogently is one that we have been working on aggressively in Financial Services to bulk up the Securities and Exchange Commission, bulk up the protections for individual investors, unsophisticated investors who might be investing either domestically or in foreign markets.

The issues that Professor Bullard talked about, we have been aggressively working on because we have been trying to harmonize the standards that are applicable worldwide in this global market in which we are operating.

What is surprising is that neither one of you has addressed what I was expecting us to address this morning in this Committee, which is the antitrust aspects of this. And it seems to me that I would have expected some discussion of what is driving us toward this greater concentration of ownerships, which, from my perspective, is cost and the drive for cost savings, and the drive for greater profits, or to minimize losses, whichever way you want to look at that—flip sides of the same coin.

And the mix of things that are going on on these exchanges now, as I understand it, we would be hard pressed to make a case that either of these mergers—well, I have not looked at NASDAQ quite as closely, but certainly the first one has substantial antitrust implications for stock ownership, stock transfers, because the New York Stock Exchange apparently has gone from trading 70 percent or 69 percent of trading to down to like 24 percent now. And most of the trading is taking place on smaller platforms electronically outside any kind of exchange.

What at least one writer has suggesting is that this is being driven by the concentration of trading derivatives, which contributed, according to that writer, 40 percent of the profits of the New York Stock Exchange. And if you put the derivatives that the New York Stock Exchange is controlling and derivatives that the German Exchange is controlling together, then you have got potentially an antitrust concern.

So, I guess my question is, let us talk about what this Committee has jurisdiction over, which is the antitrust aspects of this. Do either one of you see any particular antitrust concerns about either the prospect that the New York Stock Exchange will either merge with German Exchange or the NASDAQ domestic exchange? Do you see any adverse consequences from the control or administration of derivatives from either one of these kind of mergers taking place? That is what I want to hear because, I mean, at the end of the day, our jurisdiction in this Committee—I mean, I might invite you back to talk about all the things you all talked about in the Financial Services Committee, although I cannot invite you for that. I cannot invite you over here. I am not in control. We are not in the majority any more.

So, but it seems to me that most of what you have talked about are subjects that we are dealing with in the other Committee. I want to hear your perspective, if I can get it, on the antitrust aspects of this. Are there any antitrust implications, and are they driven more by the monopoly that we are creating about transfer of stocks, or is it being driven more by the monopoly or movement toward a monopoly that we may be creating in the control of trading of derivatives? That is a long question. I am sorry.

Mr. GOODLATTE. I will give you both a chance to answer.

Mr. HARRIS. May I answer first?

Mr. WATT. Sure.

Mr. HARRIS. There are two places where I see antitrust problems. One is in front of us and the other one is not in front of us.

The one that is in front of us is with respect to listings. If the NASDAQ is able to purchase the New York Stock Exchange, we will have one entity that will be responsible for the vast majority—virtually all listings in the United States.

Now coincidentally—I presume it is coincidental, but I do not know—the BATS Exchange just announced on Tuesday that they wanted to enter the listing business. The listing business is an extremely difficult business to penetrate because a listing is a brand; it is association with a brand. And the New York Stock Exchange and NASDAQ both have strong brands that took a long time to develop. BATS does not presently have a brand. They might in the future, but I suspect that if a listing is valuable to a company, that the BATS brand will have a challenge getting started up. So, to put all the listings into a single entity seems somewhat problematic to me. So, that is the area where there is——

Mr. WATT. Even if those listings are going to be allowed to be traded by different platforms? Is it the listing that is troubling you, or is it the trading that is troubling you?

Mr. HARRIS. No. It is the listing itself.

Mr. WATT. Okay.

Mr. HARRIS. The trading is subject to all the different platforms, and we have no problem there. There is very, very competitive markets in the equities space. But the listings are associated with control over governance, control over capital structure, and control over disclosure. And one might argue that it is best to put that under one entity so that the SEC can control all of it in a single place. But if we do believe that exchanges should be allowed to appeal to different clienteles among their issuers, then we basically preclude a significant competition by allowing this type of merger.

The other place where I have significant concern is not in front of us, but it is worth discussing. You spoke about the derivatives and the profitability in the derivatives. The profitability in derivatives has to do with the clearing houses and the fact that the clearing houses are vertically integrated with the exchanges that feed contracts to them. It is a simply a felony in the United States for us to trade a futures contract off an exchange, whereas you and I, if we wanted to right now, could trade IBM among us. We might have difficulty settling it, but that would just be a practical problem; it would not be a felony.

The exchanges and their clearing houses effectively have extraordinary market power in their successful contracts. And that is a fact already, and the aggregation of various contracts under a single holding company does not change that fact. So, if the New York Stock Exchange Euronext merges with Deutsche Borse, then we will see a lot more futures contracts aggregated under a single umbrella, but each one of those presently operates, by and large, with an awful lot of market power. It would make it very difficult for any competitor to open up a similar contract and try to trade against them.

So, the market power is already there. The notion that these exchanges are buying or merging to acquire that market power seems wrong to me. It is already there, and they are undoubtedly paying for it. So that cannot be the source of value from these transactions. The source of value is that they hope to substantially reduce their expenditures on information technologies.

Exchange platforms are essentially the same whether you are trading equities, futures, options. They are all about the same. They are electronic databases, in effect, and they have pretty much become a commodity. But to maintain two when they are both identical is very expensive, so if you combine the two into one entity, you have a great cost savings.

Mr. WATT. Let me quickly get Mr. Bullard's reaction, because my time has long since expired.

Mr. BULLARD. I think I agree with the point about the brands. The way I would see it is that listing requirements are essentially the set of rules that are imposed in order to list with that exchange. You can go trade on another exchange, but where it is listed is what determines what the rules are. And those are very much kind of corporate governance type rules in many cases. And to see the merger of those two sets of rules into one set of rules is not consistent, in my mind, with the kind of useful free market in regulatory approaches that we would like to see because that has the kind of super national oversight to make sure things do not get out of hand. And that is essentially today the SEC and the CFTC.

As to the international issue, you know, even though, as Professor Harris has pointed out, some of these have not come to pass yet, although, of course, NYSE itself exists because of the merger with a transnational set of exchanges. I think we need to look forward to what I think is a real serious antitrust problem, and that is that you will have the primary regulator of competition among exchanges missing from the picture to the extent you have the kinds of transactions Professor Harris described going on where a U.S. retail investor is buying securities traded under a German listing. Now, I do not have particular concerns with respect to German listings and German corporate requirements; in fact, they are a lot more stringent and a lot more burdensome than Sarbanes-Oxley if you actually look at them. But I do have a concern as we go down the road that we will see other jurisdictions where we will not be comfortable, and we will need to have some kind of umbrella oversight mechanism in place, or we will not have a regulator as to the competitive aspects of these exchanges.

And the inverse of our system where you have orders trading through different exchanges, and you have, as he pointed out, a lot of competition, is the more European approach where they do not push so hard for that, and where you have exchanges able to act opportunistically by having essentially sold trading privileges. And, you know, that is the kind of development that I ask who is going to be overseeing that when we have these transnational types of transactions.

Mr. WATT. Thank you, Mr. Chairman. I yield back.

Mr. GOODLATTE. I thank the gentleman.

The gentleman from Michigan, Mr. Conyers, is recognized for 5 minutes?

Mr. CONYERS. Thank you.

Professor Bullard, what is your law student organization like doing in this related activities at this time?

Mr. BULLARD. Well, as we were discussing before the hearing, there is another related SRO issue, and that is whether FINRA's authority would be extended to allow them to regulate investment advisors. And there are a number of investment advisors in the United States who would like to be regulated by a separate entity, and students at University of Mississippi, and not just the University of Mississippi. We have students in Ohio, Alabama, California, New York, Kentucky, Florida, and California—we have not heard from Michigan yet—that are all working on this project to develop a structure whereby if Congress authorizes the creation of an SRO for advisors, there would then be one ready to apply with the SEC to provide that for investment advisors.

And it is not directly relevant here, but it is structurally relevant in that the principle purpose that these students see this serving is to establish a different brand, a different set of regulatory requirements, where the SOROYA, as we are calling it, could compete with FINRA and offer different options.

The idea that exchanges might coalesce and thereby eliminate that kind of regulatory marketplace in a way is nearer in the SRO world, and there are lots of different SRO type organizations. In the United States, you have, for example, the Municipals Securities Rulemaking Board, which interestingly has essentially rulemaking promulgation authority, but then leaves examinations and enforcement to others. You have FINRA, on the other hand, which really captures the whole mix and does just about everything, including arbitration or private disputes.

So there are a lot of different models and there are lot of different models on an international scale. One model for some kind of super national authority might be IOSCO, which is the existing long-standing international group for securities regulators. Another would be something structured perhaps along the lines of the World Trade Organization. So, there are a lot of different models in which what we are seeing is the development of NGOs, the administrative state coming in and serving roles that are problematic under a constitutional authority, but are particularly problematic in deciding how are U.S. interests being protected abroad as we move into more formal transnational relationships in a lot of different areas.

Mr. CONYERS. Professor Harris, have there been any kind of student law school combinations of activities going on at the University of Southern California?

Mr. HARRIS. None in this area.

Mr. CONYERS. In any area.

Mr. HARRIS. I believe so. I know that we have students in the two schools working together on issues involving, I believe, venture capital and also, I believe, involving distressed workout situations.

Mr. CONYERS. Professor Bullard, has the antitrust division been dormant here for several Administrations?

Mr. BULLARD. I am sorry? Has the antitrust——

Mr. CONYERS. Division of the Department of Justice——

Voice. He said dormant.

Mr. CONYERS. Dormant.

Mr. BULLARD. Dormant? I cannot really speak to that. It is not an area that I follow closely enough. But in the world of exchanges, especially as a securities lawyer, I generally view antitrust activities as being a securities regulation issue. And I would say that the SEC has been dormant on a number of fronts increasingly in the time preceding Mary Schapiro's tenure. And I think that in the respect of regulating investment banks, for example, and other aspects of SEC oversight, you have seen some of those problems bearing fruit today.

Mr. CONYERS. Professor Harris, do you think there are things we could do to improve DoJ and SEC in terms of oversight and enforcement?

Mr. HARRIS. Certainly having two agencies who can reasonably believe that they have jurisdiction over similar issues is potentially problematic. The SEC, of course, has more expertise with respect to the financial markets. DoJ, when it is paying attention, potentially has more expertise over antitrust issues. And we would, of course, like to see the two of them cooperate.

I will note that the SEC, in my opinion, has actually been pretty pro-competitive in the last decade. In particular, regulation NMS is the reason why we see so much competition now among the equities markets because we basically allowed those equity markets to become electronic and compete. And electronic competition has just vastly opened the marketplace for low-cost competitors who are providing really great service.

But to your question of how they get along, they have different perspectives. I have a particular fear here in the options markets. The options markets now have a common clearing corporation called OCC, the Options Clearing Corp., which operates as an industry utility, and it serves the nine different exchanges that trade options. Those nine different exchanges are in a vicious competition with each other for order flow, and it is only because they are all served by the same clearing corp., the implication of which is that you can buy a contract at one exchange and sell the same contract in another exchange, which is a tremendous benefit to consumers.

Now if we see substantial consolidation in the option space under the control of, say, two or three different entities that own these nine exchanges, and if that consolidation leads to substantial power over this OCC—and I frankly do not know the governance structure there—if that were to result, then the options markets will start looking a lot more like the futures markets. Futures markets produce an incredible amount of revenue for the clearing houses and the exchanges that own them in this vertical structure, a structure that, of course, the Department of Justice might more readily recognize than perhaps the CFTC.

So, I would think that this would be an unattractive outcome if, as a result of mergers like this, the independence of the Options Clearing Corp. were in some way challenged.

Mr. CONYERS. Thank you, Chairman.

Mr. GOODLATTE. I thank the gentleman.

The gentlewoman from Texas, Ms. Jackson Lee, is recognized for 5 minutes?

Ms. JACKSON LEE. Mr. Chairman, let me thank you very much. I had engaged the Chairman of the full Committee and the Ranking Member of this full Committee on the importance of having a hearing on this proposed purchase really by Deutsch Bank initially with German shareholders, to hold such a hearing as quickly as possible. And I thank the Chairman of the Subcommittee and the Ranking Member of this Committee.

And let me express amazement and dismay because it looks as if we are tool-less. And I must place on the record, Mr. Chairman, my concern that the chief operating officer, Mr. Leibowitz, is not here. And I am disappointed that a short trip from New York City prevented him from being here. I can just well assume that the next trip from Germany might be even more challenging.

So, I would like to raise these questions with you, and as I do that, I am interested in the antitrust issues, but I am just going to put the information on the record so that both professors can speak from your level of expertise. If it happens to be antitrust, so be it.

But we have a very good memorandum that is prepared for us. And when you look to the issue of the Hart-Scott-Rodino review processes—7A Clayton—let me say that initially Teddy Roosevelt got it right to break up these large monopolies, to increase competitiveness, and for the 20th century it worked. And I understand that we may have to assess, but just listen to what the Justice Department has to do when there is this merger. The parties must notify the Federal Government, send them a note, or maybe you send them an e-mail, or you Twitter to them, while you are continuing to negotiate and get ready to sign the deal. Then the parties must then wait for a specified period of time, simply 30 days. That is the average. That can go in the flick of a hand—30 days to look at a complex merger such as the one before us or NASDAQ.

Then after—let's see. The parties then wait a period of time, determine through a clearance process established by the Congress. The two agencies that have to be involved decides whether to clear the merger, after which it may be consummated. So, it could be 30 days plus one, and then maybe if they are a little challenged, they can issue a second level of information. They cannot stop it. They cannot enjoin it. And only after all of that and they feel that there's comfort, they can go into the courthouse that has already narrowed the interpretation of the Clayton Act.

Literally America's hands are tied, and I have been asking, and I think it is important, for all the case law to go back and look at Section 7, to give us something to talk about with all these mergers, whether it is securities, whether it is automobile industry, whether it is TV, whatever it happens to be. It is because of the lack of teeth that we have in this particular legislation that is on antitrust.

But let me go to you, Professor Bullard, and just ask a question, and I think you were saying about the race to the bottom for the financial markets premised on these mergers. Is there some truth to that kind of analysis, and expand on your issue of the potential lack of oversight of the securities and exchange market, I think is truly one that I would be concerned about.

Mr. Harris, with this economy percolating and the global economy making some efforts, we saw job creation today increase, I believe. We see the efforts that were made, funding, stimulus dollars, American Reinvestment and Recovery Act, which is really putting this market in a direction where it is making a profit. But years past, as you well know, we moved the market from a little club of bankers and others, and shareholders are there, and it is the argument that the leaders of the stock exchange will say, which is, we need to make money. And these mergers help make money for the general public, the shareholders.

So, my question to Professor Bullard, speak to me about a race to the bottom. And what should we be looking at when we assess whether this is a right approach and whether it is anti-competitive, worry about whether we have a Clayton Act. And, two, Professor Harris, how does this skew the markets for the common man when we are talking about these kinds of mergers?

Professor Bullard first, please.

Mr. BULLARD. I should probably warn you I have a bit of a different view of the common popular theory of the race to the bottom, which is usually used to describe state corporate law, and the theory that companies will go to the state with the worst regulation.

I think that the idea of a race only makes sense when there is no higher authority that can ultimately place a check on that kind of race. And that is precisely what the Federal Government does. That is precisely what it has done repeatedly over the last 10 years. And to give you a concrete example, one of the provisions of Sarbanes-Oxley prohibits loans to executives by companies. That is precisely the kind of thing that no state law prohibited. The Federal Government stepped in because of the WorldCom scandal and decided to make that a minimum floor below which states could not drop.

Ms. JACKSON LEE. Right.

Mr. BULLARD. So in that sense, if you have that strong centralized Federal regulator, I am not concerned personally with the race to the bottom because structurally to me it just does not——

Ms. JACKSON LEE. But if your entity moves off shore——

Mr. BULLARD. I was going to add, in the national context, if the SEC continues to have both a doubling of its burdens and a having of its budget, you are no longer going to have that oversight in the U.S.. And then the race to the bottom will be a serious issue because securities regulation does supplement and, in many cases, supplant state law. If you do not have an agency, such as the SEC, that can carry out its enforcement responsibilities, then you really do have a race to the bottom. And I think that is what would happen.

Ms. JACKSON LEE. And mergers do not help the situation.

Mr. BULLARD. And in addition to that, it is a given structurally that if you go abroad, you are going to have a race to the bottom because, again, you have no formal mechanism that can impose requirements in order to constrain the competition that will exist if you do not have that oversight.

Ms. JACKSON LEE. Professor Harris. Thank you.

Mr. HARRIS. These mergers will reduce the cost to the companies who are providing their services because they reduce duplicative processes.

To the extent that they can reduce the costs if the firms remain in competition with other firms, those benefits will be passed through to the public, and that will be for the best, both for Americans and for others who use these markets, whether they are here or abroad.

Now, with respect to regulation, I think it is important to recognize that the need for regulation has changed substantially with electronic trading. So, we regulate in several different areas. We regulate trading practices. We regulate brokers and their relations with their clients. And we regulate issuers and their capital structure and their governance.

With respect to trading practices in electronic systems, there is hardly any need to regulate anymore because those computers simply do not break the rules. We still need to regulate the brokers, but the brokers are locally domiciled, and we have control over that, which brings us back to the listing issue.

So, we regulate listings or listings agencies, which are the NYSE and NASDAQ, regulate the issuers through their listing standards, with some input from the SEC. And, of course, these issues are all states' rights issues by and large. Those are places where we may have some concern with these transactions.

Ms. JACKSON LEE. Mr. Chairman, if I could ask unanimous consent to put into the record From Shame to Antitrust: New York Stock Exchange and NASDAQ/ICE Merger, and——

Mr. GOODLATTE. Let me interrupt the gentle lady. Her time has expired. We are going to do a second round, and we will return to you in a——

Ms. JACKSON LEE. I am just asking to enter into the record——

Mr. GOODLATTE. Without objection.

[The information referred to follows:]

From Shame to Antitrust: NYSE and NASDAQ-ICE Merger (NYX, NDAQ, ICE, CME)

Posted: April 1, 2011 at 7:35 am

First it was the shame that one of America's greatest names was going to effectively be foreign-owned. The NYSE Euronext, Inc. (NYSE: NYX) is currently in a pending merger agreement with Deutsche Boerse but the rumored rival deal has now surfaced. NASDAQ OMX Group Inc. (NASDAQ: NDAQ) and the IntercontinentalExchange, Inc. (NYSE: ICE) have now jointly announced a new proposal to acquire NYSE Euronext (NYSE: NYX).

There has been quite a bit of public scrutiny in the German deal. Imagine America's great stock exchange and the name behind capitalism coming mostly under what is perceived as German ownership. This new merger offer will likely have antitrust issues and will require a long review process due to the size and scale.

NASDAQ and ICE are calling their new offer a premium of 19% more than what the Deutsche Boerse offer is. A price of $42.50 per share in cash and stock is the determined value set by NASDAQ and ICE. As far as size in total, it comes to some $11.3 billion based on the closing share prices on March 31, 2011. The new offer is also said to represent a 27% premium over NYSE Euronext's unaffected stock price on February 8, 2011 (the day before the merger first surfaced).

Here are the terms of the proposal. NYSE Euronext stockholders are being offered $14.24 per share in cash. The stock component is 0.4069 shares of NASDAQ OMX common stock and 0.1436 shares of ICE common stock per NYSE Euronext share. The ultimate price depends upon where NASDAQ and ICE shares trade this morning and hereafter, but the tally comes to $42.50 per NYSE share based on yesterday's closing prices of NASDAQ and ICE.

As an American it has felt almost shameful that a brand as powerful as the New York Stock Exchange could end up in what is perceived as foreign ownership. As a market observer, it is impossible to not think that the mix of futures, stocks, and options that a Trifecta NYSE-NASDAQ-ICE exchange will have extreme power over market participants. The exchanges claim that there are very few barriers to entry and that new private and semi-private exchanges take away the business all the time. From an outsider's view that is not as clear.

Let's not forget about CME Group Inc. (NYSE: CME). The CME is the combined Chicago Mercantile Exchange and Chicago Board of Trade. Recent comments would not lead us to believe that the CME will step in for a rival bid. While there are other exchanges, this new NYSE-NASDAQ-ICE would make market participants choose from two giant powerful exchanges and a bunch of smaller exchanges and smaller trading platforms.

Pick your poison... Antitrust issues or losing a great brand to a foreign owner.

JON C. OGG

Read more: From Shame to Antitrust: NYSE and NASDAQ-ICE Merger (NYX, NDAQ, ICE, CME) - 24/7 Wall St.
http://247wallst.com/2011/04/01/from-shame-to-antitrust-nyse-and-nasdaq-ice-nyx-ndaq-ice-cme/#ixzz1IHDIXH8o

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Ms. JACKSON LEE. And I would just make an inquiry to you, and I know we are doing a second round, but it is just an inquiry. I do appreciate being informed that the COO is not here because of the potential NASDAQ/ICE merger. Since I happen to question that potential merger and am opposed to it, I am still disappointed that he is not here. But I would just make the inquiry, Mr. Chairman, will he be able to come back sooner rather than later? Will this Committee reconvene for the opportunity for us to hear him?

Mr. GOODLATTE. Well, I thank you for raising that point because we, at the outset of the hearing, made clear that his presence here was not, in my opinion, to be characterized as ducking the hearing. The Committee made the determination that because Mr. Leibowitz was confronted last night with a sudden development involving another major competing bid for the acquisition of the NYSE Euronext, that it would be inappropriate to call him to testify today. It was the Committee's decision to do so. I also announced that we would hold another hearing on the issue. The exact timing of that will depend upon a number of variables, including the Committee's schedule. But it is our hope that we will be able to accomplish that, and I will work with the Chairman of the full Committee to accomplish that.

Ms. JACKSON LEE. Thank you, Mr. Chairman. It is a very important issue. Thank you.

Mr. GOODLATTE. I recognize myself for some additional questions, and then I will recognize other Members who may wish to ask some questions as well. I have several, so I would ask you to keep your answers as brief as possible, although I know some of these are not easy to answer briefly.

First of all, I would ask both of you, why is it that the New York Stock Exchange, which is the world's largest exchange by trading volume, has a relatively small market capitalization? Do either of you know the answer to that?

Mr. HARRIS. I believe I——

Mr. GOODLATTE. Professor Harris?

Mr. HARRIS. The New York Stock Exchange market share has dropped very substantially as it competes with other electronic entities that have provided high quality service. Has been very attractive to brokers and to traders. So where the New York Stock Exchange used to have a market share in excess of 90 percent at one time, it has now dropped into the 20's. And with that and all that competition, they have had to reduce fees very substantially, and as a consequence, the market capitalization is much lower.

Mr. GOODLATTE. It is lower because the profitability of the entity is much lower.

Mr. HARRIS. The electronic trading has substantially reduced the costs of providing service in this area, and as a consequence, the business is less profitable.

Mr. GOODLATTE. In your testimony, you reflect that technology and regulations have made securities markets far more competitive in the past 15 years. And according to some estimates, this competition has shrunk the New York Stock Exchange share of the securities market from over 70 percent to under 30 percent since 1996. How has this competition affected ordinary investors, and how has it affected small and developing companies that are seeking capital? How has it affected established listing companies? Has it been a plus or a minus for each of those three areas? And I will start with you, and then go to Professor Bullard.

Mr. HARRIS. I recently did a study on the quality of markets over the last 20 years. Market quality has increased very substantially. Those spreads have gotten smaller for large companies and small companies. The aggregate sizes on the bids and the offers have increased over time. Just about every measure of market quality has improved. The public is being served by much better markets now than they used to be. And it is, I think, pretty easy to understand that the entities that are now providing service to the public are largely computers and not people. And it is not that we do not like the people, but the computers just work a whole lot cheaper. They are more reliable. They are certainly more trustworthy in the sense that they never break the rules. And they are, of course, governed by people who are trying to use them to make profits. But they are only able to make profits within the narrow confines of electronic exchanges where the rules are well defined and completely enforced.

In that environment where people can instantly move from one market to another looking for liquidity, it is very easy to find the other side, even when the markets are broken up and fragmented. And that indeed is what is happening. So, I believe that at least with respect to exchange services, the public and the small investors and small issuers have never been better served.

Mr. GOODLATTE. Thank you. Professor Bullard? Turn the microphone on.

Mr. BULLARD. I would echo that in that that is directly felt by retail investors, for example, through mutual funds who are now trading at small fractions of the cost of trading that existed 20 or 25 years ago. And the same indirect benefits accrue to issuers on those markets, including small issuers.

Mr. GOODLATTE. Sal Amuk, AMUK, an institutional broker at Themis Trading, has questioned the for-profit exchange model and argued that exchanges should be utilities that look after their customers and the markets rather than for-profit businesses that "act like bonus-seeking bankers." What are the advantages of the for-profit exchange model? Professor Harris?

Mr. HARRIS. The for-profit exchange model, when the for-profit exchange is in competition with many other exchanges, tends to innovate a lot faster than does the mutual model, and it tends to lower costs much more aggressively.

The mutual model has its advantages in that you don't have a conflict of interest between the interest of the shareholders and the interest of the customers. In the mutual model, if the directors of the exchange are looking out for the interests of the customers, then, of course, the customer comes first, although quite frequently in the mutual model, the directors are looking out for the members, in which case you have a conflict between the members and their customers.

Mr. GOODLATTE. And are there examples of the mutual exchange model? Are there any operating entities?

Mr. HARRIS. Over the last 10 years, almost all exchanges that used to be mutual model exchanges have converted to public equity exchanges.

Mr. GOODLATTE. For-profit exchanges.

Mr. HARRIS. For-profit, yes.

Mr. GOODLATTE. All right.

Mr. HARRIS. Undoubtedly, there are some left somewhere, but I frankly do not know which ones they would be.

Mr. GOODLATTE. Professor Bullard, do you have any comment on that?

Mr. BULLARD. The essential difference between a mutual model and a for-profit model is that one is answerable to the members—traders—who use the services on the exchange, and the other being shareholders. Shareholders have no loyalty other than to their company as a profit-making concern. So, there are necessarily going to be far fewer responsibilities of shareholders as such to other types of relationships that members have in the mutual context. Members of the New York Stock Exchange, for example, are directly regulated by the SEC, and that puts a significant crimp in their ability to act solely not only in the interest of making profits for the New York Stock Exchange, it also puts a serious crimp in their ability to run contrary to what might be U.S. policy in the securities markets. On the other hand, when you have got public shareholders who can be anyone around the world essentially, so I think there may be some limits on share ownership with exchanges. They are looking for one thing, and that is profits. And as much as you may hear those talking about mergers, hoping that they will be in the best interests of the United States, you know, I consider that nothing more than diplomacy. They are out there doing one thing, and that is trying to maximize value for their shareholders. And if it means going abroad, that is where they will go. If it means staying in the U.S., they will stay.

Mr. GOODLATTE. Thank you. Two more questions I will direct each of you. Do you believe that the Deutsche Borse merger will enhance or reduce New York City's role as a global financial center?

Mr. HARRIS. I do not think it will have any difference at all. The trading of securities now is not a major issue within financial markets. The financial markets, the intelligence, the where the money is made, the where the difficulties are, have to do with raising capital. They have to do with structuring transactions. They have to do with recognizing where value lies.

The actual trading in the securities and electronic markets is a commodity business, could take place anywhere. There is not a lot of money to be made in it. And, frankly, that is the reason why we are seeing these mergers is because they are trying to reduce those costs.

Mr. GOODLATTE. Thank you. Professor Bullard?

Mr. BULLARD. I just do not know the answer to that question.

Mr. GOODLATTE. Okay, very good.

Mr. BULLARD. We do not say that very often.

Mr. GOODLATTE. We certainly understand. There are questions like that out there.

And the last question I have is, some, such as Grant Thornton Senior Advisor David Weild, argue that the technological and regulatory changes that have increased competition for exchanges have helped to drive spreads and fees so low that exchanges focus on generating trading volume with large-cap companies rather than helping small- and mid-cap companies access capital. Do you agree with his analysis? Professor Harris?

Mr. HARRIS. No, I do not.

Mr. GOODLATTE. Can you explain?

Mr. HARRIS. I just do not see any evidence of it. The exchanges are actively looking for listings, both for large firms and small firms. There might be some basis in the argument on the sense that in the past, the exchanges tried to encourage dealers to subsidize the trading in the smaller firms by charging wider spreads, but standing present in the event that somebody needed to trade. It is harder to do that in an electronic environment, but that subsidy was, in some sense, a false subsidy. It was damaging traders or hurting traders when trading was normal, and it was helping only the dealers' friends when the liquidity was really necessary. It represented a regulatory problem that, frankly, I think has gone away, and I welcome that we do not face it anymore.

Mr. GOODLATTE. Thank you. Professor Bullard?

Mr. BULLARD. You know, I do not have an opinion on that issue.

Mr. GOODLATTE. Thank you.

Gentleman from North Carolina, Mr. Watt?

Mr. WATT. Mr. Chairman, I think I will pass on this round.

Mr. GOODLATTE. The gentlewoman from California, Ms. Waters. Are you ready to ask questions?

Ms. WATERS. Thank you very much, Mr. Chairman. Sorry I could not be here during the entire hearing.

And I suppose I am wondering, as many others are, about this NASDAQ/New York Stock Exchange merger. What are the implications of this merger? Are there some anti-competitive aspects of this that we should be concerned about? I suppose that is on everybody's minds, so I would appreciate any thoughts on that.

Mr. GOODLATTE. I thank the—go ahead.

Mr. BULLARD. I could repeat Professor Harris' comments, and he could repeat mine. Earlier we had a discussion about some potential impacts, and we talked about how there does not seem to be much market benefit to merging the two primary brands in U.S. markets. And that with respect to trading, where you have a system where trades can really find their best execution, to a great extent, under current SEC rules, that is an area where there is probably less of a concern, although I also noted at the time that, you know, it concerns me as to whether you will have on an ongoing basis the kind of oversight of that kind of enforced competition if the SEC continues to see restrictions on its ability to provide that degree of oversight.

Mr. HARRIS. I will introduce a new observation without commenting much on it.

The NASDAQ used to have market share approaching 80 percent in its securities. It was eroded by competition from Island and InstaNet and other ECMs. NASDAQ bought those entities in an attempt to acquire their technology and restored their market share only to see the market share drop to new entities, like Direct Edge and BATS. And now once again, NASDAQ's market share is on the order of 20 or 30 percent, I believe. Maybe it is 40 percent, I am not sure.

So, now they propose to buy the New York Stock Exchange, hopefully with a different outcome. And I do not want to comment on it; it has other dimensions, including the fact that now they will control listings if the transaction works—the control listings for both markets, and essentially be the exclusive listing agent, except perhaps for a new entrant in BATS that was just announced on Tuesday.

But I do wonder whether the continual combination is just a denial of what is ultimately true, which is that this is a commodity business in which people with computers can buy software off the shelf, open up an exchange that provides excellent service to everybody. How can you compete well against that model? And the answer is it is very difficult, but that is great for the consumer because they are getting pretty good service.

There are market fragmentation concerns by having so many competitors where, you know, there is a buyer in one market and a seller in another market. How do they ever find each other? But the answer is, there are electronic mechanisms that connect them. Many of those mechanisms are operated by the so-called high frequency traders who are in the business of basically connecting a buyer in one market to a seller in another market. And they do earn some profit from it, but in the end the consumer is better off because it is so cheap to trade.

In a world where we had perfect, perfect foresight, we might construct a single exchange that in some way would hopefully serve everybody's interests perfectly, which is impossible because people have different interests. And then it would be really easy for the buyer to find the seller. But there we would have a problem with, what about the tension between well-informed traders and large institutions? Large institutions often represent pensioners. They are often not particularly well informed, and they do not like to lose to well-informed traders. So, they patronize dark pools, these so-called hidden order systems, where they actually obtain much better executions because they do not display their orders. If they display the orders, there are a variety of strategies that allow other people to become parasites off of these institutions and ultimately hurt pensioners.

So, we have a diversity of market structures that appeal to the diverse needs of different types of traders, and to force them all into a single structure would seem pretty unwise to me.

Ms. WATERS. Well, I certainly thank you for that answer. You have certainly provided me with more information than I can digest or comprehend at this time. Thank you very much.

Mr. GOODLATTE. I thank the gentlewoman.

The gentlewoman from Texas, Ms. Jackson Lee, is recognized for 5 minutes?

Ms. JACKSON LEE. Thank you very much, Mr. Chairman.

I indicated to you that I wanted to submit into the record the article that I believe is CNN. But anyhow, just the headline, From Shame to Anti-Trust. And then I have one from Financial Times.com, and they have a very good sentence here. "The move"— and this is about NASDAQ—"is a sign that a wave of exchange consolidation triggered 5 months ago has become a battle between the world's biggest entities for poll position in an industry pressured by competition." What an irony that we have now tried to demonize competition and find a way to swallow up, to consume anyone or any entity that poses a competitive edge, or allows there to be some tension in the industry, tension in the media industry, good tension in the airline industry. And so, besides the board of directors and the shareholders, the CEO apparently gets brownie points for coming and saying, here is our next opportunity for making money. You are not making a product. You are not creating more jobs. But the way to make more money is let us, you know, just consume—put a little salt on it, a little pepper—the competitor.

[The information referred to follows:]

FT.com
FINANCIAL TIMES

Nasdaq and ICE launch bid for NYSE

By Jeremy Grant
Published: April 1 2011 13:06 | Last updated: April 1 2011 13:06

Nasdaq OMX, and **IntercontinentalExchange** (ICE) on Friday sought to break up a plan to create the world's largest exchange by making an $11.3bn cash and share offer for NYSE Euronext weeks after it had agreed a merger with Deutsche Börse.

The move is a sign that a wave of exchange consolidation, triggered five months ago, has become a battle between the world's biggest bourses for pole position in an industry pressured by competition.

It also represents a bold gamble by Robert Greifeld, Nasdaq chief executive, to propel Nasdaq into the top rank of exchanges at a time when the heavily indebted group has been wrong-footed by consolidating rivals.

Nasdaq OMX and Atlanta-based ICE are offering a total of $42.50 a share for NYSE Euronext, representing a 19 per cent premium over the offer by Deutsche Borse, made last month.

The offer consists of $14.24 in cash plus 0.4069 Nasdaq OMX shares and 0.1436 ICE shares for every NYSE Euronext. The new group would be called Nasdaq NYSE Euronext Group.

It was also a 27 per cent premium over NYSE Euronext's share price on February 8, the day before the owner of the New York Stock Exchange said it was in talks with Germany's Deutsche Börse about a deal.

The deal would create "a unified US equities market" that would "ensure that the US is better able to compete globally in a rapidly changing international market for equity trading and capital-raising", the companies said.

NYSE Euronext and Deutsche Börse have already said their combination would create the largest exchange. New York mayor Michael Bloomberg has said the US-German deal would be "very good for New York".

It would also give ICE a US futures business that would compete with the CME Group in Chicago.

As part of the proposal, ICE would buy NYSE Euronext's futures businesses, known as NYSE Liffe, while Nasdaq OMX would keep NYSE Euronext's remaining businesses, including the Euronext group of stock exchanges in New York, Paris, Brussels, Amsterdam and Lisbon, as well as the US options business.

The move would give Mr Greifeld an immediate presence in pan-European cash equities which, combined with Nasdaq OMX's existing Nordic business, would provide a challenge to Deutsche Börse and the London Stock Exchange.

A combined Nasdaq OMX and NYSE Euronext would merge their trading, listings, options and market technology businesses to create "a leading international exchange" headquartered in New York. The combination of the US exchanges would create savings of $740m by the end of the third year of completion of the deal.

Mr Greifeld said: "Our industry is undergoing a period of historic change. During the last five years more than 90 per cent of the top 100 global listings chose not to list in the US, depriving US investors the opportunity to easily invest and trade in these companies.

"The combination of the two leading US exchanges delivers an opportunity to build a global exchange platform that has the scale and growth potential to benefit investors, issuers and other market participants. We believe it would increase transparency and liquidity in US markets and create jobs as new companies raise capital."

Nasdaq and ICE would finance the cash portion of the acquisition through cash on hand and a combined $3.8bn "financing commitment".

"Both firms have received strong support from a group of leading institutions, including Bank of America and Wells Fargo, which together would be prepared to arrange fully committed financing required to complete the transaction,"

Nasdaq and ICE said repayment of debt would be financed by "the strong cash flows of the combined companies".

The companies said a combined Nasdaq and NYSE Euronext would be accretive to shareholders 12-18 months after the deal closed, and would give "double digit accretion" soon after that period.

For ICE, the deal would give it a big presence in European derivatives through its absorption of Liffe, which dominates trading on European interest rate futures.

Jeff Sprecher, ICE chief executive, said: "Given the dynamics in derivatives markets today, the pace of innovation and the need for competition, we are well positioned to bring more value to stockholders by ensuring that Liffe participates in the growth opportunities in our space."

Deutsche Börse and NYSE Euronext would together dominate European derivatives trading by controlling Liffe and Eurex, the Borse's futures exchange. But that dominant position is likely to be a key part of European antitrust scrutiny of the NYSE Euronext-Deutsche Börse deal.

Nasdaq and ICE said they believed they could "secure EU competition clearance in contract to the expectation of a deep and extended probe for the proposed Deutsche Boerse's transaction".

Nasdaq OMX is being advised by Bank of America Merrill Lynch and Evercore Group, while ICE is being advised by Lazard, Broadhaven Capital Partners and BMO Capital Markets Corp.

Ms. JACKSON LEE. I do not get it, I really do not. And so, my question, since we are in the midst of job surging and job creating, it is just a simple question. Will these mergers—and I know these are the financial markets—lead to further job creation for Americans? Do they have any impact on reversing job growth trends that we are experiencing—good news that we are experiencing? Americans need jobs, and obviously this is financial markets and very technical. Most Americans do not understand.

But let me add to that that if there was a merger, does that mean that the special, talented guys and ladies that I have come to know and being on the floor of the New York Stock Exchange, and paper falling all over everywhere—they have gotten a little bit more sophisticated. Do they get slashed in the hand? Do you cut them? Professor Harris, you talked about technology, but when you go to the stock exchange, there are still a bunch of folk running around—quite a number of jobs and also jobs that provide a good income.

And let me add this point to my inquiry. Is there any precedent—and obviously I am answering my own question, but I want to hear from you—for these types of mergers? And what have you seen, and what results have you seen with respect to these types of mergers? And I do not know whether you would assume that the bank mergers equal that, but I sort of separate out the bank mergers from the exchange. But if you can deal with this question of job creation. Can we go back and say this is really a good initiative for job creation? Are we going to see the cutting of personnel at the New York Stock Exchange? And what impact have you seen on mergers similar to this kind of financial merger?

Professor Harris and then Professor Bullard. Thank you.

Mr. HARRIS. First, let us put things into perspective. The exchange services industry is really a very small industry. There is not a lot of employment here, and, of course, employment has been dropping as computers are doing the work more effectively.

Before the New York Stock Exchange used to be a much, much busier place than it presently is, and it has gotten much less busy because they are using computers increasingly. And it will get less busy in the future undoubtedly.

The vast majority of the people who trade on the floor of the exchange are honest people and always have been. But there are unfortunately a good number of them who were not honest. We had scandals with the specialists. We had scandals with brokers. We had people who were violating rules because we could not see that they were violating the rules. That does not happen with computers anymore, and that is a good thing.

So, to be concerned about their jobs, absolutely. There are people about whom we should be concerned. But at the same time, we do not want people to be plowing our fields behind oxen because that is the way they always did it. There have been changes that allow us to be far more productive, and we feed far more people now because we use powered machines to plow our fields. In the same way, we are able to do far more in the exchange services arena using computers.

Now, with respect to job creation in general, there is basically within the Western world a single market for capital. Capital moves quite easily among countries, and while we would like to have the managers of that capital to be working in the United States, the sources of capital are all over the place. And they will serve up capital to people who have good ideas regardless of how the financial system is organized.

So, we need to do things to make it possible for those transactions that take place here to support jobs in this country. But the big story, will capital go to the best ideas, that is going to happen no matter what. And getting capital to the best ideas is the way we get the most jobs in the United States.

Within the exchange services industry, we would like to see a very strong industry that is reliable, safe, that does provide sensible employment where it is possible. And for that we just need to have well-educated people who can manage money and who know how to connect the buyers and sellers, the savers to the investors.

Ms. JACKSON LEE. Professor Bullard?

Mr. BULLARD. I think I would largely echo virtually all of that. I think just more bluntly, in the short term, there is no question there will be job lost, and there will be jobs lost in New York. Whatever merger happens, the CEOs will ensure that the promise of savings happens, and it will be in the form of some job losses. In theory, what happens to those people is then they find jobs with the new competitors of this new entity, and they continue to thrive and——

Ms. JACKSON LEE. Maybe.

Mr. BULLARD [continuing]. Engage in competition, in theory.

As to job creation going forward, I think that is a function of whether the United States is producing the bodies that are going to be paid these higher incomes for providing this high-end, very sophisticated service, which is setting up the kinds of exchanges that do the best job for the markets. And all you have to look at is just the training and testing scores that you see in the United States to make judgments about where we are in that competition. I think some of the news is good and some of the news is bad, but I think that is really where you are going to find the answers.

Whether in the long term, the bottom line is whether those exchanges are going to be paying U.S. people or are they going to be paying other people.

Mr. GOODLATTE. The time of the gentlewoman has expired.

Ms. JACKSON LEE. I thank the gentleman.

Mr. GOODLATTE. The gentleman from Ohio, Mr. Chabot, is recognized for 5 minutes?

Mr. CHABOT. Thank you, Mr. Chairman. I will not take up the 5 minutes. It was just a point that I wanted to make, or at least ask a question related to the questioning and the answers that we just heard.

Professor, you had mentioned that there were fewer people working on the floor of the Stock Exchange nowadays, and that we have computers that have replaced some of those folks. And obviously, if you are one of those folks, that is very unfortunate.

But what has it done relative to the, say, the per cost transaction to the consumer, the person that is either buying or selling stocks? What has been the trend over time, even though we have fewer people there?

Mr. HARRIS. The trend has been extremely obvious and in one direction. The cost of trading to individuals and institutions has dropped very significantly. We see this both in bid out spreads that have dropped from—it used to be a quarter, 25 cents; it is now typically one penny or two pennies.

We also see it in the form of much lower commissions. Now, this is in the brokerage industry, not in the exchange services industry.

But it is an allied industry subject to the same technological innovations. Brokerage commissions have dropped very substantially, both for institutions and for individuals, where individuals now can trade essentially as much as they want for about $10. It used to cost them $150 or more. Institutions used to pay 5, 7, 10 cents a share; now they are typically paying 1 and a half to 3 cents, and they can pay and get excellent quality service for less than a penny.

Mr. CHABOT. And so, the consumer, small investors—and would it be accurate to say that nowadays, other than after the meltdown, in which case I am guessing that a lot of small consumers either got out or were scared out of the market or whatever. But the trends other than that, more and more people are investing, I would say, on their own and in larger percentages of the population than in the past? Would that be accurate?

Mr. HARRIS. That certainly has been the trend since World War II, and I believe it continues.

Mr. CHABOT. And so, the consumer—if the consumer is the person who buys and sells stock, especially the small consumer, they would be making more money in each transaction because they are paying out less costs, or at least the expenses are lower to them. Is that correct?

Mr. HARRIS. Yes. Any time the expenses are lower, the trading activity is more profitable or, alternatively, less costly.

What we hope by this is that if the consumer believes that they can use the markets to move their money from the present to the future so that they can retire, or move money from the present to the future so that their children can go to a university, if they can do that more cheaply than they otherwise could do it, then they will save their money in the markets, and that will make money available to companies who hopefully have good ideas and generate more employment.

Mr. CHABOT. Thank you very much, Professor.

Professor Bullard, I do not know if you——

Mr. BULLARD. When you were talking about there are more direct investors, I think there has actually been declining direct investment in equities as opposed to investment through other collective investment vehicles. These savings——

Mr. CHABOT. Do you mean mutual funds in particular? Do you mean——

Mr. BULLARD. Mutual funds, but there you have seen equally drastic reduction in trading costs as well. So, investors are benefitting in that context just as well.

Mr. CHABOT. Okay, very good. Thank you very much. I yield back, Mr. Chairman.

Mr. GOODLATTE. I thank the gentleman.

I would like to thank both of our witnesses for their testimony. They have made, I think, an important contribution to our understanding of competition in this market. And as I noted at the outset, because of the rapid developments that have occurred within the last now 15 hours, we will revisit this issue at the appropriate time with the appropriate witnesses and taking heed of the concerns raised by the Ranking Member, Mr. Watt, that the Subcommittee do so with the fairness that one would expect of us.

So without objection, all Members will have 5 legislative days to submit to the Chair additional written questions for the witnesses, which we will forward and ask the witnesses to respond as promptly as they can so that their answers may be made a part of the record.

Without objection, all Members will have 5 legislative days to submit any additional materials for inclusion in the record.

And with that, I, again, thank the witnesses and declare the hearing adjourned.

Mr. HARRIS. Thank you.

Mr. BULLARD. Thank you.

[Whereupon, at 2:22 p.m., the Subcommittee was adjourned.]

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